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STATE FOR WHA/CEN, WHA/EPSC AND EEB/OMA
TREASURY FOR ANNA JEWEL, SARA GRAY AND WILLIAM FOSTER

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TAGS: EFIN EAID ENRG EPET PGOV PREL IMF HO
SUBJECT: GOH SEEKS IMF AGREEMENT TO UNLOCK BUDGET SUPPORT

REF: A. 07 TEGUCIGALPA 1531
¶B. 07 TEGUCIGALPA 1798
¶C. 07 TEGUCIGALPA 1944
¶D. 08 TEGUCIGALPA 57

¶1. (C) Summary: Honduran Finance Minister Rebeca Santos and Central Bank President Edwin Araque will travel to Washington January 31 to attempt to lay the groundwork for an IMF Standby Agreement that President Zelaya could finalize and announce when he comes to town for the national prayer breakfast February 7. Sources here tell us the two sides remain far apart over public sector salaries, the last of six issues that have held up negotiations. An agreement could provide USD 50 million in IMF balance of payments support and potentially unlock considerably more than that in direct budget support from other donors, including the World Bank. Zelaya probably also wants an IMF deal to provide an implicit seal of approval for his proposal to purchase Venezuelan oil on credit through Petrocaribe. Post is concerned that, without adequate up-front conditionality, Zelaya will renege on any commitments to the IMF, pocket the financial resources it unleashes and use them to skate through the remaining two years of his term without undertaking serious economic reforms, leaving his successor to deal with the consequences. End Summary.

Background

¶2. (SBU) According to local IMF Resrep Mario Garza, the GOH formally approached the IMF last October about resuming discussions on a follow-on agreement to the one that expired in April 2006. Garza said this was the first indication of seriousness on the part of the GOH in an IMF program since President Manuel Zelaya came into office in January 2006. Talks to renew the previous agreement were derailed in April 2006 over IMF concerns about the rapid increase in public sector salaries, which caused the 2006 budget to miss IMF targets. An attempt to rekindle discussions in April 2007 faltered when the GOH team reported Zelaya would not accept the IMF's terms. The breathing room provided by nearly USD 4 billion in official debt relief and strong revenue gains (thanks in large part to U.S. Treasury technical assistance to GOH tax authorities) clearly reduced Zelaya's incentive to be on an IMF plan. By the summer of 2007, the IMF was expressing growing concerns over both the quantity and quality of government spending, rapidly expanding domestic credit and the potential impact on economic growth and financial stability in the medium term (ref A).

Lowering the Bar

¶3. (SBU) In addition to fiscal and monetary issues, the IMF has also attempted to engage the Zelaya Administration on the need for microeconomic and structural reforms to attract investment for long-term economic growth. In particular, the Fund has highlighted the need to reform the energy and telecommunications sectors, both characterized by inefficiency and corruption, and to implement CAFTA. However, after two months of tense discussions following the resumption of talks in October, the two sides agreed to leave those structural reform issues off the table and pursue only a 12-18 month Standby Agreement that would seek only to stabilize reserves (which fell by about USD 100 million -- about 4 percent -- last year, and would have fallen by more if not for a USD 50 million grant from Taiwan that arrived late in the year) and achieve fiscal balance. A three-year Poverty Reduction and Growth Facility (PRGF), could follow if the GOH is prepared to engage on broader reform issues.

¶4. (SBU) Over the course of discussions, the two sides narrowed their differences to six broad policy issues:

-- public sector wage policy
-- public pension funds (borrowing from)
-- subsidies (primarily for fuel and electricity)
-- rationalization of electricity rates,
-- civil service reform, and
-- monetary policy.

The overall goal is to keep the fiscal deficit at or below one percent of GDP (it was more than 2 percent in 2007) and stabilize reserves, expected to come under pressure as remittances from Hondurans living in the United States -- equal to a quarter of GDP -- slow or decline.

¶5. (C) Garza said the two sides had reached basic agreement on all the above issues except wages. Under current policies, he said, which the GOH refuses to change, the public sector wage bill is expected to rise 19 percent this year, after already rising sharply in the previous two years (30 percent in 2007 alone). The IMF is insisting growth in salaries not exceed 13 percent. The GOH is trying to manipulate the issue by changing the metric to percentage of GDP, thus reaping the benefit of a recent change in Central Bank statistical methodology, which restated GDP upward by roughly 20 percent, and assuming continued strong economic growth will stabilize the ratio at around 9 percent. The IMF is not buying. It wants the GOH to show it is prepared to resist wage demands from teachers and other public employees and to stabilize payrolls.

¶6. (C) On electricity policy, the state-owned electric company, ENEE, is losing money at a rate of about 3 percent of GDP a year because of a combination of poor management, technical losses, theft of electricity and rates that do not cover costs (ref B). The GOH raised rates on industrial customers in December and on most residential customers (other than those consuming less than 150 kwh a month) in January -- an average increase of 16 percent. It has committed to further raise rates, and target existing electricity subsidies to the truly needy, resulting in a cumulative average increase of 27 percent. The Fund considers these steps to be adequate to "stop the bleeding" at ENEE for purposes of a Standby Agreement. It is not requiring any additional steps to restore health to the ailing electricity sector or to deal with ENEE's arrears to private power producers, which the World Bank estimates total 6 billion lempiras (USD 317 million) and rising.

¶7. (C) On the monetary front, the IMF is recommending a crawling peg that will devalue the lempira -- fixed at 18.9 to the dollar since 2005 -- by 3 percent by the end of 2008. Garza said this would be just sufficient to keep parity with the expected difference in U.S. and Honduran inflation over the next year. The IMF also wants the Central Bank to raise reserve requirements on banks and increase its base interest

rate (overnight rate) by a further 150 basis points (it has already increased 150 basis points since mid-2007) to 9 percent.

¶8. (SBU) Garza does not foresee an agreement going to the IMF board until late March. He said that under an agreement, the IMF would likely provide a one-time USD 50 million balance of payment injection to the Central Bank. But he said disbursement would be backloaded, contingent on the GOH fulfilling conditions.

Other Donor Support Potentially at Stake

¶9. (C) Probably of more concern to Zelaya than the USD 50 million in balance of payments support that the IMF might provide is the impact of an IMF agreement -- even a watered-down Standby Agreement -- could have on decisions of other donors with respect to direct budget support. Several donors have been holding back budget support because of the lack of an IMF agreement. For example, the World Bank has USD 30 million in funds, earmarked for budget support this year, that may be reprogrammed in February (probably to projects in Honduras) if conditions, including an IMF agreement, are not met. Local representatives tell us the EC may have a further USD 20 million to provide, Germany USD 24 million and Spain USD 6 million. Garza estimates a total of USD 150 million could be at stake.

¶10. (C) In a January 22 donors meeting here, Garza briefed donor reps on the Fund's ongoing discussions with the GOH and stressed that whether the Standby Agreement it contemplates would be sufficient for them to release their support funds would be a decision each donor would have to make. He said Finance Minister Santos was focused on what Honduras needed to do to unlock those funds during her December 2007 visit to Washington.

¶11. (C) In a meeting with Embassy and USAID officers January 24, Garza suggested organizing a meeting of key multilateral and bilateral donors to inform them of the risks, noting that they may face tremendous pressure to disburse budget support funds if a Standby Agreement is reached.

Petrocaribe

¶12. (C) Underlying these discussions is the simultaneous GOH bid to sign a deal with Venezuela to import fuel on concessional terms through Petrocaribe (ref D). According to public statements by GOH officials and briefings provided to donors and to the Honduran Congress, such a deal could provide the GOH USD 345 million over the first year. The GOH is already banking on USD 285 million for 2008, under the optimistic assumption that oil could begin to flow in April. Politically, Zelaya and his team are arguing that, without a Petrocaribe deal, it will be impossible to maintain the fuel subsidies -- currently costing the GOH about 3.6 billion lempiras (USD 190 million) a year -- in the face of record-high world oil prices. However, Petrocaribe agreements typically require that proceeds be used for public investments, not subsidies. Furthermore, the GOH has already committed in its submission to Congress (in part to satisfy domestic critics and IMF conditions) that all proceeds will be placed in a trust fund at the Central Bank to be used to recapitalize ENEE, construct hydroelectric plants and invest in social and agricultural projects under the direction of a "committee of notables."

¶13. (C) The IMF is urging that this cash, along with USD 80 million the GOH is expecting to receive from the recent auction for a fourth cellular telephone license, be sequestered at the Central Bank and earmarked for infrastructure projects, preferably to be monitored by the World Bank. However, World Bank staff told us that, based on previous Honduran experience with "trust funds," they are not

interested. Some Honduran experts have commented publicly that the Central Bank's charter does not permit it to manage funds for infrastructure investments.

Comment

¶14. (C) We suspect President Zelaya plans to use his trip to Washington February 7 to announce he has reached agreement with the IMF on a Standby package, whether he has in fact done so or not. He will then use that supposed agreement to claim legitimacy for a Petrocaribe deal, which would be part of the agreement, and to pressure other donors to release budget support funds that they have been holding back for lack of an IMF program. Although donor reps here have told us they plan to base disbursements on actions taken by the GOH, their resolve could easily waver in the face of pressure here and from their capitals to disburse. Zelaya's goal, we are convinced, is to squeeze enough liquidity out of Venezuela, the IFIs and bilateral donors to skate through the remaining two years of his term, maintain fuel subsidies and teacher salaries, avoid any difficult economic reforms and pass the bill onto his successor. This suspicion is supported by his track record of managing the windfall from debt relief.

¶15. (C) Whether Zelaya will succeed is another question. Finance Minister Santos, in our view, sincerely wants a meaningful IMF program to discipline her own boss and create conditions that will allow Honduras to maintain the healthy growth rates of the last three years beyond the end of Zelaya's term. Donor discipline will be essential to assure that her vision, not that of her boss, prevails. The World Bank appears to be divided on the issue. Country director Adrian Fozzard is inclined to support an IMF Standby and release budget support funds on the grounds that it would at least impose some discipline on Zelaya for the balance of his term. Other staffers think that would be throwing good money after bad. The Bank's stance will be key, as will the USG's. End Comment.

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